US Agency for International Development
Study of Innovative Practices in SME Finance

Case Study: DFCU Leasing Limited (Uganda)

Public/Private Partnering to Grow Profitable Leasing

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Background

This paper is part of a six-study series that was conducted by the U.S. Agency for International Development (USAID), with assistance from Deloitte Touche Tohmatsu. The purpose of the study series is to identify and document innovative practices in SME financing. The information for this study was obtained from on-site visits and interviews with management of each of the organizations. The interviews were conducted by Suzanne Nolte Saunders of USAID's Economic Growth, Agriculture and Trade Bureau, Office of Economic Growth, with assistance from Teresa Mastrangelo of Deloitte Touche Tohmatsu for the Uganda and South Africa cases and from Maribeth Murphy of Deloitte Touche Tohmatsu or the Chile case. For more information on the overall series or to find the other study documents, please go to http://www.usaid.gov/economic_growth/egat/eg/tech-financial

Acknowledgments

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List of Selected Interviews:

- Katimbo-Mugwanya E., Executive Director, Supervision, Bank of Uganda
- Juma Kisaame, General Manager, DFCU Leasing Limited
- Willie P. Ogule, General Counsel, DFCU Group
- John S. Taylor, Group Managing Director, DFCU Group
- Jack Thompson, Chemonics International, SME Finance Advisor, SPEED Project

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I. Introduction

The Ugandan leasing industry is still in its infancy with leasing representing only about 4 percent of total private sector credit in Uganda[1]. This case study reviews Uganda's leasing industry's leader, DFCU Leasing Limited. DFCU Leasing recognizes the growth potential of leasing and acts as a catalyst to grow the entire industry by:

- Expanding its own profitable operations
- Educating the marketplace
- Creating a more effective legal and fiscal environment
- Promoting financial sector development by lobbying for new instruments

There are considerable benefits to making leasing available in a developing economy, as well as challenges. Some of the benefits are listed in the table below.

Table 1: The Case for Leasing

Benefits to SMEs	
Accessibility	Leasing can allow new businesses with limited capital and credit history or small businesses without a history of financial statements to quickly boost their operations, as long as the cash flow from operations is sufficient to cover the lease service payments. It is not a direct substitute for lending since it does not directly increase operating capital, but where it enables the borrower to avoid using operating capital to purchase an asset, it can have similar results.
Security	Since lessors own the assets and use the leased asset as the primary security, SMEs can still be eligible for lease financing when bank loans would not be available.
Maturity	SMEs often have no access to long-term financing (over one year). Leases can provide longer term financing, often with terms from one to five years.
Payment terms	Lease payments can be structured to mirror individual cash flow patterns of the lessee, in contrast to bank loans, which have standardized repayment schedules.
Process time	Because of the collateral-backed nature of the financing, less analysis is required of the customer's creditworthiness, assets or capital base. Less time is needed for assigning other collateral, and simpler documentation can be used. (However, this may be countered by the time it takes to acquire the assets, usually from foreign vendors.)
Benefits to Lessors	
Security	Since lessors own the assets and can repossess them immediately upon non-payment, the security is easier to claim than when the financier has to file a legal claim against a client's collateral, often through poorly developed court systems.
Funds usage	Because the lessor purchases equipment and then leases it there is no opportunity for the lessee to use the funds for other purposes.

[1] Source: Calculated from Bank of Uganda Private Sector Credit figures from *Economic and Financial Indicators*, available from July 2002, http://www.bou.or.ug/Econ_June2002.PDF, accessed August 2002.

Benefits to Financial Sector Development	
Cash flow based lending	Moves the financial industry to rely more on cash flow based lending than on credit history and formal historical financial records.
Diversification	Broadens product range and competition in financial services, which should lead to lower cost financing.
Capital markets	Helps to deepen and broaden domestic capital markets, as leasing companies seek new funding via loans, bond offerings or securitizing their lease receivables[2]
Macroeconomic Benefits	
Technology transfer	Finances the import of more advanced equipment
Productivity	Increases use of more efficient equipment.

Some of the challenges that need to be addressed when attempting to grow leasing in Uganda and other developing countries include:

- Accessing sufficient funding to purchase equipment.
- Dealing with uneducated or unsophisticated customers with poor financial records. Common characteristics of Ugandan SMEs include:
    - Limited or no credit history
    - Lack of suitable collateral
    - Under capitalized
    - Family owned with corporate governance issues
    - Lack of investment in information technology and in market information
    - Poor debt repayment culture
    - Unregistered businesses (due to red tape, tax avoidance or lack of understanding)
    - Little ability to share information or lobby for their industry due to absence of associations
    - Minimizing loss or impairment of leased assets.
    - Quickly re-leasing or re-selling repossessed assets.
- Working under legal, tax and regulatory frameworks that are obsolete, vague, or inappropriate.
- Relying on courts systems that are not sufficiently developed.
- Managing all the costs associated with leasing to SMEs, particularly those related to financing and purchasing the assets, assessing client credit worthiness, calculating deal terms, monitoring clients and assets, and developing staff expertise.

The objective of this case study is to document how DFCU is navigating through the challenges to grow the Ugandan leasing industry and provide lease financing to SMEs. The case begins with some background on DFCU Leasing and its parent company, DFCU Limited. It continues with highlights of some of the major issues that DFCU is working with donors on regarding the legal, regulatory and fiscal environment and a

2 Lawrence W. Carter, *IFC's Experience in Promoting Leasing in Developing Countries. 1977-1995* from IFC's Lesson of Experience Series. World Bank, 1996, Page 5.

description of DFCU's role in educating business leaders and policy makers. Following are comments on DFCU Leasing's competitive position in the market, plus details on its services, clients, leasing processes, and approaches to staffing. The case then outlines how DFCU Leasing is addressing their funding needs. It concludes with some of DFCU's recommendations on how to further improve Uganda's financial and business environment to increase SMEs access to financing and better position them for growth.

DFCU's commitment to creating an environment that supports financial sector growth combined with their demonstration that leasing can be profitable makes them an exemplary model for financial innovation in a developing country. Our hope is that this case will encourage donors, governments and private sector entities in other regions and countries to develop this market segment. Ultimately, our goal is to see an increase in leasing in developing countries in order to finance SMEs and act as a catalyst to financial sector growth.

For lasting growth to take place in Uganda, the skills of SMEs need to be further developed. This case does not focus on SME skill development, other than noting the coordination between DFCU Leasing and United States Agency for International Development (USAID) business development centers and highlighting DFCU's commitment to educating business leaders.

II. Background

DFCU Limited

DFCU Leasing is a 100 percent owned subsidiary of DFCU Limited. DFCU Limited was incorporated in 1964 by CDC Capital Partners (formerly Commonwealth Development Corporation) and the Government of Uganda to provide subsidized finance for the country's economic development. It is owned by four shareholders with the ownership percentages noted below:

	Dec. 31, 2001
CDC Capital Partners (formerly Commonwealth Development Corporation)	35.3 percent
Deutsche Investitions- und Entwicklungsgeselschaft mbH (DEG)	24.7 percent
International Finance Corporation (IFC)	21.5 percent
Uganda Development Corporation	18.5 percent

DFCU Limited's shareholders have changed the role of DFCU over time to being a commercially focused organization that charges market rates, while still being committed to economic development in Uganda. DFCU Group includes DFCU Limited and its subsidiaries. The wholly owned subsidiaries are Uganda Leasing Company Limited (legal name for DFCU Leasing) and DFCU Bank Limited. DFCU Group also owns 62 percent of Rwenzori Properties Limited and 50 percent of Housing Finance Company of Uganda Limited (HFCU). Over the last three years, 1998-2001, DFCU Group has moved from the 11th largest financial institution in Uganda to the 5th in terms of assets. Although annual growth has been 20 percent over this period, the Group Managing

Director, John Taylor, has gained commitment from the Board of Directors that profit growth be subordinated to development objectives.

DFCU Leasing

Uganda Leasing Company Limited was established in 1994 by the Development Finance Co. of Uganda (DFCU), Nile Bank, the IFC, the CDC, and the DEG, and commenced leasing in 1995. DFCU acquired 100 percent of Uganda Leasing Limited in 1999 to form DFCU Leasing. DFCU Leasing's target clients are SMEs, which comprise 90 percent of the Ugandan businesses, provide 50 percent of the jobs and contribute two-thirds of the national income.[3] In addition, DFCU Leasing targets SMEs because of their contribution to bottom-up development, poverty reduction, and the formation of a middle class.

III. Summary Results

DFCU's lease portfolio has grown from UGX 21.8 billion to UGX 25.6 billion from 2000 to 2001,[4] with a projected net increase of 12 percent over the next two years. Meanwhile, net profits have also grown substantially with projected increases of over 30 percent per year for the next two years. DFCU's growth projections reflect a controlled growth strategy that promotes portfolio expansion while maintaining and refining effective internal controls.

Table 2: Highlights for 2001 (000,000)[5]

Gross finance lease receivables	UGX 25,648 ($14.7 million)
Net profit from continuing operations	UGX 2,473 ($1.4 million)
Payments in arrears (>90 days)	3 %
Gross write-offs 1998-2001	< $50,000
Average cost of funds	12 %
Average interest rate on leases	18 %
Clients	About 500
Employees	22 as of 6/28/02

DFCU Leasing's portfolio of assets comprises trucks, buses, construction and production equipment, furniture workshops, and other types of equipment and vehicles. 60 percent of the leased equipment is used. DFCU Leasing's main office is in Kampala, but the organization is expanding into rural areas. With funding from DfID, DFCU recently opened a leasing office in Lira in May 2001, and with funding from USAID's SPEED (Support for Private Enterprise Expansion & Development), opened offices in Mbarara in

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[3] Figures taken from a presentation from Juma Kisaame, General Manager, DFCU Leasing, April 30, 2002. Original source is the International Finance Corporation (IFC).
[4] 1 USD = 1,795 UGX
[5] Financial information taken from DFCU Leasing Company Limited Directors' Report and Financial Statements for the year ended 31 December 2001. The profit figure for 2001 is net of a grant received from the Department of International Development (DFID).

September 2001 and Mbale in February 2002 and will open one in Hoima in October 2002.

IV. Legal, Tax, and Regulatory Issues

Leasing is not an entirely new concept in Uganda. In the 1960s and 1970s a few banks financed motor vehicles (primarily) through hire purchase and leasing. With the economic decline of the 1970s and 1980s, large insurance companies exited the market, the rule of law was weakened, and leasing became very risky. In 1994, DFCU Leasing began operations in an attempt to reinvigorate the leasing market. The current legal framework has enabled leasing through its consumer hire-purchase law, but it lacks specific legislation for business leases and for leasing by non-deposit taking institutions. As a result, DFCU Leasing has used as its main forms of guidance the Income Tax Act and VAT statute.

Specific aspects of the legal, regulatory, and fiscal environments that are being assessed for revision in order to promote growth in leasing and financial services in general are noted below:[6]

- The current tax legislation allows the lessees to record the asset's depreciation on their books rather than the lessors who are the owners of the assets. This is a significant deterrent for financial institutions to enter the leasing market since it prevents the lessor from enjoying the tax benefits associated with booking the depreciation expense.

- Value Added Tax (VAT) is assessed on the entire leasing transaction and is passed onto the lessee, but about 80 percent of DFCU's clients cannot claim credit on their VAT expenses since they fall beneath the VAT registration thresholds. As a result, the leasing transactions cost even more for those businesses least able to afford it.

- The Financial Institutions Bill that is currently being proposed stipulates that leasing organizations should be regulated similarly to deposit taking institutions. This would add new burdens on leasing institutions around such topics as provisioning, capital requirements, and board requirements, while not necessarily providing additional protection to the consumer or additional stability to the financial services industry.

- There is no Leasing Act in Uganda that stipulates the rights and obligations of lessors and lessees towards each other. Many developed countries have avoided specific leasing legislation and expanded leasing operations through common law, accounting guidelines, precedent, and practice. However, given the state of development of these supporting industries in Uganda, leasing

[6] A detailed discussion on the legal and regulatory issues are included in a draft report, *The Regulatory Environment for Leasing in Uganda and Proposals for Regulatory Reform*, dated June 28, 2002 by Fiona MacCulloch at The Deregulation Project, Ministry of Finance, Planning and Economic Development. For further information, please contact Ms. MacCulloch at dereg1@africaonline.co.ug.

legislation may prove more effective in providing conclusive direction on the rights and obligations of lessors and lessees.

- Leasing legislation is not currently flexible enough to support a range of diversified products such as operating leases, contract hire, and plant hire.

DFCU is working closely with USAID's SPEED project and DfID to provide a private sector perspective on these and other issues related to leasing legislation, regulation and tax treatment. DFCU also participates in the change process by serving on an implementation committee set up by the Bank of Uganda to advise the government on legislative and tax changes to strengthen financial institutions and increase their provision of funding to SMEs.

Regarding the legal issues above, DFCU supports donor recommendations to:

- Allow the lessors to record depreciation on the assets it leases out
- Omit non-deposit taking organizations from the Financial Institutions Bill
- Provide training to SMEs on the benefits and facts of VAT registration and VAT administration
- Develop specific leasing legislation that defines the rights of lessors and lessees and outlines the specific types of leasing transactions, including financial and operating leases, contract hire, and plant hire agreements
- Define the appropriate framework for the introduction of additional financial products such as factoring

In addition to the above legal framework issues, improvements in the operations of the commercial courts would facilitate enforceability of legal contracts and reduce time and costs associated with contract disputes. The courts need to be automated to allow for faster and cheaper processing of cases and the arbitration services need to be buttressed with better trained and more arbitrators. Under the current system, DFCU said that it would take two to five years to seize assets by going through the courts. To address some of these issues, USAID is sponsoring CADER (Centre for Alternative Dispute Resolution), a project under the Ministry of Justice, to speed up dispute resolution for commercial transactions.

This involvement of DFCU in coordination with donors has been productive in educating the government on leasing and in helping to develop an environment that fosters competition in leasing.

V. Educating the Marketplace

DFCU has provided leasing training to Ugandan business people in workshops throughout the country and has worked with donors such as USAID and DfID to organize leasing conferences and produce educational materials such as the Leasing Handbook for Uganda – July 2001(funded by DfID). DFCU has held four leasing workshops serving 100 to 300 people each and plans on offering two more during 2002. In addition, DFCU's General Manager has presented leasing at multiple government and donor meetings targeted at business leaders, and is hosting the 7th African Leasing Convention in Uganda to be held on September 23 to 26, 2002. In addition to presenting information on financial leases, DFCU is also educating business leaders and government officials on operating leases, in anticipation of being able to offer them shortly. In being an advocate for leasing and a source of information, DFCU increases its business prospects, but also improves SMEs understanding of financing options.

VI. DFCU Leasing's Competitive Advantage

Competition

DFCU Leasing is the market leader in Uganda with approximately 80 percent market share. DFCU faces competition from the East African Development Bank (EADB) in leasing and from the European Investment Bank's (EIB) "Apex" loans, in an alternative credit product -- very low interest loans channeled through local banks. The EADB recently started leasing; originally, their minimum transaction was $100,000 and it normally takes a number of months for EADB to process the lease. EADB recently secured funds from FMO (Netherlands Development Finance Company) for leases up to a maximum of US$80,000 to SMEs employing fewer than 100 people. Information is not yet available on the progress of this program.

The European Investment Bank (EIB) "Apex" loans are channeled through several banks (including DFCU Bank Limited) for on-lending to SMEs. In general, the EIB loans have a seven-year term. They currently are available to the banks at 4 percent interest, but stipulate that the maximum margin that the banks can make is 6 percent, which results in an interest rate of 10 percent to the client. Because of these low-cost high-margin Apex funds, the banks are moving down market to SMEs. As these banks look for low-risk, credit-worthy clients, they target DFCU's larger clients, luring them in with 10 percent versus the 18 percent rates they are paying on leases. The impact has been that DFCU is losing some of its bigger clients to the banks and is being forced to look further down market for new customers. DFCU management has responded to this competition with a concerted effort to continue to grow profits by reducing monitoring and processing costs and standardizing its products.

Advantage

DFCU Leasing has developed multiple areas of competitive advantage. Some of these strengths are highlighted in the table below.

Table 3: Characteristics of DFCU's Competitive Advantage

Deal Flexibility	Ability to offer customers customized financing packages to suit their business needs and cash flow stream. The highly trained staff and sophisticated software used by DFCU allows them to use balloon payments and structure customized pay schedules to increase the ease of payment for its customers. This ability to be flexible also allows DFCU Leasing to finance customers who are creditworthy but would not be able to comply with rigid bank security requirements, thus reaching a broader customer base.
Responsiveness	Ability to process deals within two weeks. This is much less than EADB and EIB and allows DFCU to process an increasing volume of leases.
Cost Management	DFCU Leasing has developed an array of suppliers from whom it purchases used and new equipment. 60 percent of the equipment leased by DFCU is used, which leads to considerable cost savings.
Equipment Preservation & Lease Monitoring	DFCU has invested in staff and technology in order to monitor its leased assets. In-house engineers regularly check on the assets; vehicle-tracking software allows management to locate DFCU's trucks at any time; and, lease officers and management use regular reporting and client visits to manage for any clients who are delinquent in their payments. DFCU insures all of the leased assets and offers insurance premium financing to clients to help them insure their own assets.
Deposit Requirement	DFCU Leasing requires that customers make a 15 percent security deposit on the leased assets. This deposit provides DFCU with interest-free financing for further asset purchases and it confirms the customer's commitment to the lease.

Through each of these items, the additional critical element has been the capability and commitment of the management and staff. The General Manager, Juma Kisaame, developed a high level of expertise in leasing during his two years of training provided by two expatriates from DfID. Mr. Kisaame's leadership and vision has enabled him to build the leasing operation from four to 22 people since 1998. In addition, the Group CEO, John Taylor, has reinforced the organization's commitment to ethical business practices by having the board adopt the Ethical Business Code of Practice which requires that DFCU and its clients meet standards with respect such factors as the minimum wage rate, health and safety conditions, use of child labor, and maximum number of hours worked.

VII. Services

DFCU Leasing's main product is the financial lease. It added insurance premium financing (IPF), a new product, in April 2002, to help clients maintain insurance on their own assets. In addition to these formal services, DFCU also provides supply linkage consulting to clients and procurement information that helps clients source equipment for leases. DFCU does not have direct charges for these less formal services. Information on the financial leases, insurance financing, and supplier linkages is included below.

Financial Leases

Some basic information on DFCU's financial leases is noted in the table below.

Table 4: DFCU Financial Leases – Overview of Terms

Size of Leases	UGX 2 – 500 million (~ $1,200 – $290,000); average is about UGX 85 million (~$50,000)
Repayment Period	2-5 years; average is 2.5 years
Interest Rate	15-30 percent; average is 18-20 percent for transactions > $50,000 and higher for lower lease amounts (forecasted to drop as rates continue to fall)
Deal Processing Time	Maximum of 2 weeks
Lease Currency	US$ or UGX to match lessee income
Nature of Equipment	Any durable asset, plant, equipment, machinery, commercial vehicles, business cars, computers (Excludes nuclear or military equipment or equipment that supports illegal or non-industrial industries such as pornography, prostitution, illicit drugs, or businesses based on tax evasion or which employ forced labor of any kind.)
Cash Down Payment	15-20 percent of equipment cost
Asset Ownership	DFCU as the lessor maintains full ownership of the asset throughout the lease period
Option to Purchase	Exercised by lessees at the end of the lease at up to 5 percent of cost
VAT	Charged on rentals, both capital and interest costs, where applicable
Insurance and Maintenance	DFCU insures assets and passes on the cost to the lessee; maintenance is the lessee's responsibility

Insurance Premium Financing

DFCU Leasing's Insurance Premium Financing (IPF) facility allows the SMEs to meet their insurance obligations associated with their own assets while making payment installments over 10 months. SMEs who chose to use this facility obtain premium quotations from insurance underwriters. DFCU Leasing then negotiates terms and executes the agreements. DFCU Leasing pays the full premium to the underwriter and the insured repays the premium in monthly installments ranging from 4 to10 months. The facility benefits the lessees by providing them an alternative source of working capital and ensuring they maintain insurance on their own assets. The facility benefits the underwriter by giving it more secure receivables, which increases its liquidity and capacity to settle claims. It also helps it reach and retain new customers. For DFCU Leasing, this facility provides more stable clients since their business assets are insured. Because of the uniqueness of this product in the Ugandan marketplace, much time and effort was spent to train DFCU staff, underwriters, brokers and agents, prior to its introduction. This product was designed after a similar product available in Kenya, and DFCU received support from Jubilee and Insurance Company of East Africa to develop it.

Supply Linkages

DFCU Leasing has worked in several cases to facilitate supply chain linkages in markets where the entrepreneurs are too small or lack technical know-how to compete. One example is the linkage of small milk suppliers to large dairies in Mbarara. DFCU leased milk coolers to the small suppliers and tanks to the large dairies. The new equipment helped the milk suppliers save 30 percent of the milk formerly wasted. DFCU worked in collaboration with DfID on this project. DFCU's assisted the dairy industry to equalize the level of milk supply and, as a result, stabilize prices over the year, by leasing milk coolers, tankers, and encouraging the production of powdered milk in peak periods. DFCU has also contributed to maintaining level maize production by encouraging an investor to set up a large maize processing facility, with assets leased from DFCU that has helped to integrate small producers into the larger maize trade. These supply linkages help DFCU build more reliable clients and help the clients gain more reliable demand for their products.

VIII. Target Clients

DFCU Leasing has three development goals when leasing equipment to customers:

1. To modernize production methods through new equipment and increased efficiency
2. To improve the health of employees or clients (medical equipment or ability to increase health standards in production)
3. To provide access to capital for small and medium sized businesses who lack credit history and have no or limited capital

In general, DFCU sees SMEs as clients with less than 100 employees. Some additional statistics on the composition of DFCU Leasing's portfolio as of June 2002 are listed below:

- Forty percent are referred by current clients who are suppliers to the new applicants, thus providing DFCU with a good character reference
- Forty percent are existing clients with repeat business
- Fifteen percent are other referrals, usually with guarantees attached
- Five percent are new
- Twenty percent of clients are registered businesses
- About three percent are women

DFCU Leasing has built a substantial base of clients which allows it to grow primarily through repeat business and businesses linked to current clients, thus reducing much of the risk that accompanies expanding its client base. Regarding the low percentage of clients who are women, DFCU management is working to grow this percentage to 20 percent by 2004. This is a business imperative as DFCU has had a lower arrears rate with female clients. In a separate leasing program that uses matching funds from DfID, DFCU Leasing expects that 30 percent of the clients will be women. See more information on the DfID grant program in Section XI. Funding Sources and Plans.

IX. Credit, Control and Equipment Processes

Customer Assessment and Approval

Customer assessment is broken into two processes:

1. Initial Screening
2. Rigorous Credit Appraisal

During the initial screening, applicants are logged into a database, complete a screening form and come to a one-hour screening meeting with a loan officer. In addition to basic information that the applicant puts on the screening form, the loan officer spends time assessing the applicant's character and making judgments without formal financial statements. The officer documents the results of this meeting and circulates them to three managers to decide whether to proceed with the credit appraisal. In some cases, where clients do not have good financial records or understanding of leases but are near either the Lira or Mbarara business development centers opened under the SPEED project, the DFCU officer will refer them to the center for training. The business centers help get the clients ready for leasing by assisting them with the development of cash flow statements and with the operational and accounting details of financial leases.

The credit appraisal process includes a more rigorous review and completion of a Credit Proposal that reflects an assessment of the components of the client's business as shown in the following table.

Table 5: Factors Assessed in the Credit Appraisal Process

Business	Type, market share, competition, sustainability, customer base, export potential, technical aspects, environmental practices – DFCU only approves leases with clients who comply with the World Bank's environmental standards
Management	Ownership structure, competence, credibility, succession plans
Security	Cost and adequacy of leased asset to cover lease transaction value, additional security offered, creditworthiness, enforceability of repossession clauses, and ability to sell/re-lease assets in case of default, legal due diligence
Financial Situation	Ratio and cash-flow analysis -- with and without leased item -- bank statement review, references from bankers and other business associates, credit check with auditors
References	Guarantees by current DFCU Leasing customers

Based on the above findings, proposed terms and conditions are developed for the applicant for the amount to be financed, type of equipment financed, additional security requirements, and security deposit amount, lease period, interest rate, and all relevant fees. The lease officer submits the credit proposal to his or her supervisor, the General Manager, and the credit committee for approval.

Credit Committee Review

The General Manager of Leasing presents the Credit Proposal to the credit committee (CREDCO) for review and approval. CREDCO is made up of the five-member executive committee of the DFCU Group, which includes the Group CEO and Chairman, and heads of Corporate, Leasing, Finance and the Group Secretary. The Group CEO and Chairman will normally chair CREDCO meetings, but may ask the heads of Corporate or Leasing to take over in his presence or absence. At least three members of the executive committee need to be at each CREDCO meeting. If this is not possible, one or both of the resident board directors can fill in for the executive committee member(s). The levels of approval authority are:

- DFCU Leasing's General Manager: $20,000
- DFCU's Managing Director: $1 million
- DFCU Board: leases greater than $1 million

DFCU Leasing extends leases to about two out of every ten clients that apply and six out of every ten for which credit appraisals are completed. These results indicate that the weeding out process between the inquiry and application is effective. DFCU Leasing does get a number of referrals from DFCU Bank; in which case, the above rigor may be reduced depending on credit history and knowledge of the lease applicant.

Equipment Procurement

Financing

DFCU Leasing will only purchase equipment after ensuring sufficient resources are available from the DFCU group or external loan commitments. The Group Treasurer and Head of Leasing will seek to balance foreign currency risk, both in amounts and in timing. When DFCU Leasing sources funds from floating interest rate borrowings, it will limit its interest rate risk by writing floating rate leases. Where this is not feasible, DFCU Leasing includes clauses in its lease contracts that allow for adjustment of lease rental in the event of substantial fluctuations in borrowing costs. As DFCU Leasing continues to grow its portfolio, financing becomes a major constraint. See Section XI. Funding Sources and Challenges for further discussion on this.

Selection and Cost

DFCU Leasing leases equipment that is clearly identifiable, removable, and that may be leased or sold in the event of repossession on default or returned at the end of the lease term. Special care and conditions are applied when leasing specialized or limited use equipment or equipment subject to rapid obsolescence (for example, computers). The lessee is responsible for sourcing the equipment and negotiating the price and purchase logistics. However, DFCU has found that the less experienced clients often end up trying to purchase from middlemen who inflate the prices, have little idea of importing or customs procedures, and often do not even have a fax or email to use in communicating with suppliers. As a result, DFCU employees assist with the asset selection, negotiation and procurement, often using a database of reliable suppliers they have developed and with whom they can verify costs or recommend alternative sources.

One issue that DFCU faces is that there is rarely sufficient stock of the assets on hand, which requires the leased items to be imported, taking three months on average. DFCU estimates that 80 percent of the assets it purchases must be imported. 15 percent are available locally, but are manufactured overseas, and 5 percent are manufactured locally. Because DFCU's demand is spread thinly across a variety of assets, the low stock of assets held by local suppliers will remain a constraint until there is increased demand either through increased leasing or outright purchases.

Portfolio Management

DFCU Leasing will diversify its risks across industry, equipment types, regions, and client exposure. In general, DFCU Group's commitment to any one client does not exceed 50 percent of the total assets of the client, and DFCU Leasing's exposure to any one industry does not exceed 25 percent of its lease portfolio. Exceptions to the client exposure rule may be made when the excess of the limit is covered by adequate security.

Table 6: Net Lease Investment plus Approvals by Sector
As of March 31, 2002

Passenger Transport	19 %
Construction, Drilling, Wood & Metal Working	16 %
Agriculture/Ag. Processing	14 %
Commerce	10 %
Cargo Transport	8 %
Fuel Transport	8 %
Manufacturing	6 %
Printing & Publishing	6 %
Health	3 %
Education	3 %
Other: includes legal, financial and other services	7 %

Table 7: Net Lease Investment plus Approvals by Equipment
As of March 31, 2002

Trucks	23 %
Buses	20 %
Construction, Drilling, Woodworking	16 %
Production	14 %
Fuel Tankers, Dispensers	7 %
Printing & Photo Processing	7 %
Cars, 4WD Vehicles, Minibuses, Pickups	4 %
Medical, Pharmaceutical	3 %
Tractors	2 %
Other: includes milk coolers, communications equipment, dry cleaners, generators, sewing machines, solar powered systems, office equipment and other	4 %

Geographic Distribution

The leases as of March 31, 2002 were primarily to lessees in Kampala (58 percent) with 22 percent in the western part of Uganda and the rest spread over the eastern, central and northern regions. DFCU management expects this proportion to change with the new offices and estimates that 50 percent of the business will be generated from upcountry offices by the end of 2004. The eleven highest denominated leases make up about 30 percent of the total lease portfolio, with the biggest one being about 4 percent of the portfolio.

Purchase

DFCU Leasing purchases assets for leasing after the heads of Leasing, Finance, and Legal divisions have ensured that all pre-disbursement conditions and appropriate legal documentation has been satisfactorily completed. This step may include a check that:

- All prepayments have been received, including security deposit, facility fees, legal costs, and any other fees
- The legal documentation has been completed, such as the Master Lease Agreement, Finance Schedule, chattel of legal mortgage, personal guarantees,

landlord waivers, bank waivers, and any other documents pertinent to each case
- Valid pro forma invoice from the supplier to DFCU Leasing has been obtained
- In the case of used assets, inspection and verification of the asset by a qualified person

When DFCU Leasing purchases the asset, it pays the supplier the cost and pays the attendant taxes direct to the Uganda Revenue Authority. On acquisition of the equipment, it will be registered in the name of Uganda Leasing Company, with DFCU holding the title. DFCU will transfer the equipment to the lessee in return for a certificate of acceptance that will be filed with the original title. Once the lease is paid off or the asset is sold, the transfer of title will be authorized in writing by the DFCU Group CEO.

Procurement of Used Equipment/Vehicles
About 60 percent of the equipment leased by DFCU is used. In addition to being more economical, the technology of the used equipment is often more appropriate for the Ugandan market than new equipment. DFCU Leasing engineers will inspect all used equipment/vehicles before they are purchased to ensure they are in good condition and worth the cost.

Insurance
The legal division is responsible for ensuring that all leased assets are sufficiently insured and that both the lessor and lessee are protected by insurance for any damages or third-party liability arising from the use of the asset. Leased assets are required to be insured at their market value prior to transfer to the lessee and at 20 percent or more over book value in subsequent years.

Lease Pricing

DFCU Leasing prices its leases based on its cost of funds plus:
- Risk associated with the lessee, their business and the type of equipment
- Market/competitor lease rates
- Lease term
- Size of security deposit and value of additional security
- Currency risk

The cost of funds is based on the marginal cost of funds of the DFCU Group after covering operating costs, loss provisions, and projected returns to the Group shareholders. Leases may include any or all of the following interest and fee elements:
- Interest on pre-lease expenditures
- Interest on leases (fixed and variable)
- Penal interest on default
- Interest-free security deposit (cash) from the lessee -- normally at 15 percent of the amount financed to be reimbursed less any outstanding at the end of the lease

- Facility fee – normally at 1.5 percent per annum (non-refundable) on approved projects
- Legal costs of registering documents (e.g. stamp duty)
- VAT on rentals and facility fee in accordance with the law
- Termination charges
- Option to purchase – normally at 5 percent of the amount financed
- Insurance premium

The financial personnel compile the costs and compute a leasing interest rate using DFCU's sophisticated software, which they check against a manual calculation. The culmination of the above pricing components yields lease prices that are 5 to 15 percent higher than bank loans (and significantly lower than the average microfinance loan effective interest rates of between 40 percent and 50 percent). While more expensive than bank loans, DFCU's clients often do not have the option of a bank loan as they are not able to obtain credit due to lack of credit history, collateral, business sophistication, or they have already reached the maximum level that banks will lend them. Therefore, even though the leases may be priced higher than bank loans, they represent financing that the client would not have been able to access otherwise.

Once the credit assessment and pricing has been completed, DFCU Leasing uses software that allows it to set the payment terms to coordinate with customers' business cycles. For example, for schools that receive two payments each term, DFCU Leasing sets the lease payments for the same time period.

Collateral Security

While DFCU Leasing's main security is the leased asset itself, in many cases it may seek additional security to control for risks associated with the lessee's reputation, financial situation, the nature of the leased asset, and the amount of investment at stake. This security may take of the form of financial investments or instruments, mortgages on property or chattel, guarantees, life insurance policies and post-dated checks. All equipment and property that is taken as security are fully insured, have market values ascertained, and have photographs taken and kept on file. DFCU's legal division reviews all collateral for sufficiency. The insurance policies for any mortgaged property or equipment are assigned for the benefit of DFCU Leasing, first, then the lessee.

Reporting and Monitoring

DFCU Leasing has implemented comprehensive monitoring and reporting procedures, managing predominantly by exception. Management generates daily arrears reports and monthly reports to monitor the portfolio of leases. The monthly reports include a report on each lessee, an arrears aging analysis, and summaries of the lease principles, income and bad debts provisions. As soon as DFCU notices a missed payment, it will investigate the client's situation via a call or visit. At least annually, credit officers complete an investment review for each lessee that is reviewed by their managers and that includes third party feedback, macroeconomic factors, and any additional information that they can obtain on the client.

DFCU Leasing uses a risk rating system to determine which customers need to be monitored closely. All customers are assigned a risk rating from A (little or no risk – lessee of undoubted standing) to E (high risk – non-performing lessee). Lessees classified under categories D (watch list borrowers) and E will be monitored via monthly investment reviews that are prepared for CREDCO until they are reclassified to a risk level of C (Lessee representing acceptable business risk) or better. The review will indicate whether the credit risk is improving, stable or deteriorating. DFCU Leasing does not offer facilities to borrowers classified as categories D and E.

Equipment Inspection

DFCU Leasing engineers will inspect leased equipment at least annually and leased vehicles every six months. During the vehicle inspections, in addition to reviewing the condition of the vehicle, the engineer notes the engine and chassis numbers to make sure that they have not been changed or replaced. DFCU also installs a car-truck monitoring system on all vehicles worth more than UGX 10 million ($5,700) to be able to track the whereabouts of the vehicles at all times. DFCU management acquired this system from a firm in Denmark at a discounted cost of $10,000 in return for being a pilot location. The system is especially useful to identify if lessees attempt to take vehicles outside of Uganda in order to sell them. If the engineer, after inspecting the leased asset, concludes that the lessee cannot adequately maintain the asset, he will require that lessee enter into a formal maintenance contract with a qualified third party.

Provisioning and Collections

DFCU Leasing makes a general provision of two percent on the Uganda shilling-denominated finance leases and equipment stock and three percent on dollar-denominated leases and stock. Directors make additional provisions on the outstanding capital costs of leases that they consider doubtful, leases more than 90 days in arrears. To minimize arrears, DFCU Leasing requires lessees to write post-dated checks or standing orders for payment of the gross rentals due over the lease period. DFCU discourages bounced checks and late payments by charging penalties.

Repossession

DFCU Leasing repossesses equipment/vehicles as soon as arrears exceed three months, except for accounts for which reasonable circumstances can be verified. The repossessed asset will only be given back to the lessee after reducing arrears to five working days or less. DFCU Leasing may repossess assets at any time. DFCU staff carries out most of the repossessions, only calling on collection agents when staff fails to trace the assets or when the assets are in dangerous or inaccessible locations. All expenses accruing as a result of the repossession such as towing, parking, and repair are charged to the lessee. DFCU Leasing has been successful in working directly with their clients to repossess their assets, only having complications in two cases wherein the clients took DFCU to court for asset repossession.

One week after repossession, if the lessee has not cleared his/her arrears, DFCU will sell or re-lease the asset. Due to high resale value of most of the equipment, DFCU Leasing normally recoups 99 percent of the book value when the asset is sold or re-leased.

X. Staffing

Under the leadership of the General Manager, DFCU Leasing has grown from four to 22 people since 1998. As the company has grown, its leaders have expanded the compensation package to be more reflective of employee performance. DFCU offers all employees a bonus, a defined contribution retirement scheme to which the company contributes 12.5 percent of salary costs and employees contribute 7.5 percent of their basic salary, and severance of one month's pay in the event of separation. The bonus for credit officers is calculated based on the volume of loans they manage, the gross amount, days arrears of their portfolio, and lease processing speed. Some of the directors and senior staff are eligible for executive incentive pay based on the growth in valuation of the company. All employees are also eligible to financial support for continuing education, mortgages, and cars, which is helpful in employee retention, growth and morale.

The General Manager recruits the majority of the employees from universities, targeting graduates with degrees in engineering, accounting, and economics. The result of this recruiting strategy is that the average age of staff members is 24 years old. To train the new staff members, DFCU Leasing provides training workshops, mentoring and on-the-job training.

DFCU implemented an intern program in 2000 in collaboration with the local university in order to expand the number of professionals with financial services experience. DFCU brings in six interns every six months who are recent graduates, two of which go to DFCU Leasing. Of the interns brought in so far, eight have taken permanent positions in the DFCU Group.

XI. Funding Sources and Plans

Loans

DFCU Leasing sees funding as its main constraint to further growth. At the present time, DFCU Leasing borrows the maximum allowed from DFCU Limited at the local Treasury bill (T-bill) rate. These loans accounted for 63 percent of DFCU Leasing Company's total borrowing of UGX 12.7 billion as of December 31, 2001. DFCU Leasing has additional loans from their shareholders, IFC, CDC, DEG, and from EIB, Allied Bank International and Jubilee Insurance. The average cost of DFCU Leasing's borrowings is about 12 percent. In addition to debt financing, DFCU Leasing's cash deposits collected from lessees amounted to UGX 3.8 billion as of December 31, 2001 and represent interest-free financing.

Bond Issuance

To expand leasing activity and reduce the cost of funds, the DFCU Group is working on a UGX 30 billion/ 3-year bond issuance, of which UGX 10 billion would go to DFCU Leasing. This bond would be the fourth one issued on the Uganda Securities Exchange. Prior bonds issued are: East African Development Bank (EADB) in 1998 for three years; Eastern and Southern African Development Bank (PTA Bank) in 1999 for five years; and MTN Uganda Limited in 2001 for four years. DFCU plans to issue the bond at a few percentage points premium over the 180-day Treasury bill rate, at a fixed interest rate, and estimates that the cost to issue such a bond would be an additional two percentage points.

Factoring

In addition to the bond issuance, DFCU Leasing is exploring other avenues of financing such as factoring their lease receivables and assigning their income streams. The current legal and regulatory environment does not support factoring so DFCU is working with the Bank of Uganda to gain support to develop the appropriate legislation and procedures.

Donor Grants

DFCU has received donor grants from the UK's Department for International Development (DfID) and USAID that have been used to fund training, lease evaluation programs, and the setting up of rural leasing offices. An additional grant was received from DfID in 2002 in the form of a £1 million challenge (US$1.6 million) grant, matched by DFCU, under the Financial Deepening Challenge Fund Scheme. This grant allows DFCU Leasing to work with a riskier client base and design new products, using smaller leases (£25,000 maximum). DFCU expects women to represent 30 percent of the clients in this program and estimates the loss provision to be 20 percent in contrast to their current 3 percent. As of July 2002, DFCU Leasing had completed £1.2 million in leases under this program.

XII. Additional Challenges

In addition to the financing challenge, DFCU Leasing's difficulty in hiring skilled staff threatens its growth, as does its commitment to flexible deal terms.

- The General Manager has been trying to hire a deputy to assist with the leadership of the company but has found it difficult to find someone with the required skill set and capacity to quickly learn the complex leasing business. In the absence of a strong deputy, he is not able to delegate decision-making as much as he would like. Although he is extremely capable and knowledgeable about the individual clients, in order to lead the company into this next growth stage he will need to withdraw more from the daily operations to focus on strategic matters such as the bond issuance and influencing new legislation.

- DFCU Leasing's commitment to flexible deal terms is one of their major strengths. However, as the company's portfolio grows, the General Manager will need to ensure that its leasing software and processes can continue to support the variation in deal terms. It may be attractive to management to standardize the deals in order to simplify the monitoring, but they anticipate this approach would not be as appealing to clients.

XIII. DFCU Recommendations

While doing the research for this case study, DFCU management shared some of their recommendations for the way forward in regards to the leasing industry, the financial sector in general, and SME development in Uganda. These recommendations build upon the legal and tax recommendations cited earlier in this report but highlight important corollary work that needs to be done.

- Increase efficiency of bank payment system to speed up cash movements. GTZ is working on this.
- Develop the venture capital industry (would need to overcome Uganda's low capital base) and capital markets; develop an industry of IPO consultants who help SMEs do IPO's and take a cut of the funds raised may facilitate the latter.
- Develop business associations to increase market knowledge and advocacy.
- Simplify processes for business registration and rationalize business laws to make them consistent and understandable.
- Form a credit reference bureau to collect and disseminate credit information.
- Encourage donors to assist with the development of a local sustainable consulting and business support services and facilitate skills and technology transfer through supply chain linkages.

These recommendations are helpful in creating a road map for moving forward. They are also representative of issues faced by many other developing countries.

XIV. Conclusion

DFCU Leasing demonstrates strong leadership in their development of a solid and profitable business model and their commitment to moving the legal and regulatory environment forward so that it fosters responsible financial sector growth. The management has been adept at shaping their products and processes to respond to the local businesses which themselves are in the process of developing management expertise and market strategies. DFCU's leaders have been innovative in developing an array of cost minimizing and risk reducing processes and procedures, and in training local staff to lead and run the business. Furthermore, their commitment demonstrates for how development and profit objectives can work in a synergistic fashion to effectively contribute to growth of the financial sector.

However, given the low rate of leasing in Uganda, much more work needs to be done to draw more competition to this financial sector and to increase the availability of affordable leasing to SMEs. We hope that the profitable model for leasing that DFCU provides as well as the expected improvements in the legal and tax environment will encourage more leasing organizations to enter Uganda's market as well as other markets with similar characteristics.

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